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IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. [redacted] 94

FRED T. HOGAN, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

## PETITION FOR A WRIT OF CERTIORARI

**to the United States Circuit Court of Appeals For the Fifth Circuit**

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TO THE HONORABLE THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The petitioner, Fred T. Hogan, prays that a writ of certiorari issue to review that part of the opinion and judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered February 25, 1944, wherein it was held that petitioner did not make a sale of an interest in an oil and gas leasehold estate, and that he is not entitled to treat the resulting profit as long-term capital gain under Section 117 of the INTERNAL REVENUE CODE.

## Opinions Below

The Memorandum Opinion of The Tax Court of the United States (R. 91-93) is unreported. The Opinion of the Circuit Court of Appeals (R. 121) is reported at 141 Fed. (2d) 92.

## Jurisdiction

The jurisdiction of this Court is invoked under Section 240(a) of the JUDICIAL CODE as amended by the Act of February 13, 1925. The Opinion and Judgment of the court below was entered February 25, 1944 (R. 121).

## Question Presented

1. Where an interest in an oil and gas lease is assigned and the assignor retains and does not sell a fractional interest in the oil and gas in place, is this a sale and the profit capital gain under Section 117 of the REVENUE ACT OF 1938 (App. p. 13), or is it a sublease and the profit ordinary income under Section 22 of said Act? (App. p. 12).

## Statute and Regulations Involved

The statutes and regulations involved will be found in the Appendix, infra, pp. 12 to 15.

## Statement

This is a companion case with CHOATE v. COMMISSIONER and COMMISSIONER v. CHOATE (C.C.A., 10th Circuit Court of Appeals, decided March 13, 1944), —Fed. (2d) —. There is a conflict on one point between the decision of the Circuit Court of Appeals for the Fifth Circuit in this case and the decision of the Tenth Circuit Court of Appeals in the case of

COMMISSIONER v. CHOATE. A petition for writ of certiorari is being filed simultaneously herewith in the cases of CHOATE v. COMMISSIONER and COMMISSIONER v. CHOATE. The petitioner was a member of the same partnership of which Choate was a member and the tax liability involved in this case and in the CHOATE cases arises out of the same transaction.

On December 18, 1936, petitioner acting for himself and L. H. Choate and W. G. Choate, acquired an oil and gas lease by assignment from one Roy R. Brown. The lease had been originally executed by Mrs. M. L. Baker, the fee owner, and covered a tract of land situated in Upton County, Texas. After the lease was acquired from Brown, a partnership was formed under the name of Choate & Hogan to own, develop and operate the property for the production of oil and gas. Petitioner owned a one-half interest in the said partnership. Subsequently, the partnership developed the Baker lease by drilling six producing oil wells thereon. Said wells were completed prior to October 11, 1938. On the latter date, Choate and Hogan, acting for the partnership, entered into a written contract (R. 71) to sell the lease to McAlester Fuel Company, for a cash consideration of $110,000 to be paid by the buyer, and the contract further provided that the sellers were to except and reserve to themselves, their heirs and assigns, an overriding royalty of 1/8th of 8/8ths of all oil and gas produced and saved from the lease by the buyer. On August 22, 1938, Choate & Hogan executed an assignment (R. 28) of the lease, together with all the equipment thereon, to the Sylva Oil Company (nominee of McAlester Fuel Company, R. 64), and in said assignment it was provided, among other things, that "assignors herein expressly reserve to themselves, their heirs and assigns, and *do not assign or convey* to the assignee herein, 1/8th of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by the Sylva Oil Company."

In the partnership return filed by Choate & Hogan for the year 1938, the profit from the sale of the property was reported as long-term capital gain pursuant to Section 117 of the REVENUE ACT OF 1938. The respondent determined that the transaction with the Sylva Oil Company was a sublease rather than the sale of a capital asset and that the profit could not be treated as long-term capital gain. He treated the cash consideration of $110,000 as a lease bonus, allowed depletion thereon at the rate of 27½% (Sec. 114(b) (3) of the REVENUE ACT OF 1938, App. p. 13), and taxed the remainder as ordinary income under Sec. 22(a) of said Act (App. p. 12).

In his computation, respondent made no allowance for the undepreciated cost of the equipment ($23,090.60), which was on the lease at the time of sale and held that such undepreciated cost was recoverable through depletion allowances applicable to production from the retained interest of ⅛th of 8/8ths.

The Tax Court held (1) that petitioner was not entitled to treat the transfer of the interest in the lease as a sale, but must look to depletion for the return of his capital; and (2) that the unrecovered cost of the equipment on the lease at the time of the transfer is to be deducted in full from the cash consideration in determining the amount of gain subject to the depletion allowance (R. 91-93).

Both the petitioner and the Commissioner appealed and the United States Circuit Court of Appeals for the Fifth Circuit sustained The Tax Court on both points (R. 121). In the companion cases of W. G. Choate v. Commissioner and Commissioner v. W. G. Choate, supra, the Circuit Court of Appeals for the Tenth Circuit affirmed The Tax Court on the first point and reversed it on the second.

## Specification of Error to Be Urged

**1. The court below erred in holding that petitioner did not make a sale of a part of his interest in the Baker lease and that the gain realized is not taxable as long-term capital gain under Sec. 117 of the *Revenue Act of 1938* (App. p. 13).**

## Reasons Relied Upon for the Granting of the Writ

First. There is a direct conflict between the decision of the Fifth Circuit Court of Appeals in this case and the decision of the Tenth Circuit Court of Appeals in the case of Commissioner v. Choate, supra, on the question of whether the cost of the equipment on the lease at the time of the transfer is deductible from the cash consideration of \$110,-000 in computing the gain. The Fifth Circuit Court of Appeals held that the cost of the equipment is deductible from the cash consideration; the Tenth Circuit Court of Appeals held that it is not so deductible.

Both the Fifth and Tenth Circuit Courts of Appeal held that the taxpayers were not entitled to treat the transfer of the interest in the lease as a sale and the resulting profit as long-term capital gain. Each of said courts held that the taxpayers' rights are determinable by depletion. The interest in the lease and the equipment were disposed of as a unit in a single transaction. By the terms of the sales contract the sellers agreed to sell an interest in the lease together with all equipment thereon and title to the interest in the lease and the equipment on the lease was conveyed by a single instrument of assignment. Should this Court grant the petition for writ of certiorari which has been applied for in the case of Commissioner v. Choate, the decision in which is in conflict with the decision of the Fifth Circuit in this case, it will necessarily be required to examine and construe both the contract of

sale and the assignment, and no additional burden will be imposed on this Court if it also undertakes to review the decision of the Fifth Circuit Court of Appeals in this case on the issue as to whether the transaction was a sale or a sublease. As hereinafter pointed out this is a question of first importance to the oil industry as a whole, and the Court is respectfully urged to grant this petition and review the decision of the Fifth Circuit Court of Appeals on said issue.

SECOND. Approximately sixty-five per cent of the known oil reserves in the United States are located in the States of Texas, Louisiana and Mississippi, which States are included within the Fifth Judicial Circuit of the United States. There are also substantial oil reserves in certain of the States embraced within the Tenth Circuit, such as Oklahoma, New Mexico and Colorado. Assignments of oil and gas leases are made in said States practically every day in the year. A customary practice in the industry is for the assignee to pay the assignor a cash consideration with the assignor retaining an overriding royalty or an oil payment in a certain amount payable out of a fraction of the production. An important question of Federal law which has not been, but should be settled by this Court arises in the case of each of such assignments, namely: for Federal tax purposes, are transactions of such character sales of capital assets, and do they give rise to capital gains or losses which are limited by Section 117 of the REVENUE ACT OF 1938 (App. p. 13), or are they so-called subleases, the gain and loss on which is recognizable in full for Federal tax purposes? The Fifth Circuit Court has arbitrarily held that the transaction is a sale if an oil payment is retained by the vendor but that it is a sublease where the retained interest is stated in terms of an overriding royalty. CULLEN v. COMMISSIONER, 118 Fed. (2d) 651; WEST PRODUCTION CO. v. COMMISSIONER, 121 Fed. (2d) 9; MCLEAN v. COMMISSIONER, 120 Fed. (2d) 942; FLEMING v. COMMISSIONER, 82

Fed. (2d) 324; ROESER & PENDLETON, INC., v. COMMISSIONER, 118 Fed. (2d) 462 (all by C.C.A. 5th). The Tenth Circuit Court of Appeals made the same distinction, COMMISSIONER v. LEWIS, 142 Fed. (2d) 709, and CHOATE v. COMMISSIONER, — Fed. (2d) —. These rulings have been made notwithstanding it is the settled law of Texas that an oil payment and overriding royalty are each real property of like kind and character. STATE, ET AL., v. QUINTANA PETROLEUM CORP., ET AL. (Supreme Ct. of Texas), 134 Tex. 179, 133 S.W. (2d) 112; SHEPPARD v. STANOLIND OIL & GAS CO. (Austin Ct. of Civil Appeals, writ of error refused), 125 S.W. (2d) 643. Thus the distinction made by the Fifth and Tenth Circuit Courts between an oil payment and an overriding royalty is a distinction without a difference. See also LEE v. COMMISSIONER (Fifth C.C.A.), 126 Fed. (2d) 825, where it was held that oil payments and overriding royalties are to be treated alike for depletion purposes.

The effect of the decisions of the Fifth and Tenth Circuits has been to deprive taxpayers of the special benefits accorded them by the statutes relating to taxation of capital gains, which statutes were intended to be and are remedial in character. Under the said decisions, a taxpayer cannot make a sale of an oil and gas lease and secure taxation of the gain at capital gain rates if he retains an interest in the form of an overriding royalty, and this is true notwithstanding every essential element of a sale is present in the transaction, namely (1) Parties competent to contract; (2) mutual assent; (3) a thing, the absolute or general property in which is transferred from the seller to the buyer; and (4) a price in money paid or promised. (BUTLER v. THOMSON, 92 U.S. 412.) Thus, the question is of the utmost importance to the vast number of taxpayers who own oil and gas leases. The question is also important from the standpoint of the Treasury because under the decisions of the Fifth and Tenth Circuits,

as they now stand, a taxpayer owning an oil and gas lease can effect a transfer of it in a manner which will permit him to control the amount of gain or loss thereon which will be recognizable for tax purposes.

THIRD. This Court has affirmed and reaffirmed the doctrine that in tax matters substance always controls over form. U. S. v. PHELLIS, 257 U.S. 156; HELVERING v. TEX-PENN OIL CO., 300 U.S. 481;SMITH v. HIGGINS, 308 U.S. 561; and GRIFFITHS v. HELVERING, 308 U.S. 355. The Circuit Court of Appeals for the Fifth and Tenth Circuits in the cases cited, supra, applied an arbitrary rule of thumb or yardstick in determining whether the transactions were sales or subleases. If the reservation was in the form of an oil payment, the transaction was held to be a sale; if stated in terms of an overriding royalty, the transfer was held to be a sublease. Thus, the decisions were made to turn entirely and exclusively on the type of reservation that was contained in the instrument of conveyance. Form and form alone has been the dominating and decisive guidepost followed in rendering the said decisions and judgments. The type of reservation has been applied as an all-exclusive test in determining the nature of the transaction. Proof of this fact is ably demonstrated by the incongruous results reached in CULLEN'S case where despite the fact that the twelve leases were conveyed by a single instrument in a single transaction, the Fifth Circuit held as to the nine leases in which overriding royalties were retained that the transfers were subleases, and as to the three leases in which oil payments were retained that the transfers were sales. The court below has given no heed whatever to the substance of what was done. Accordingly, its decision and judgment conflict in principle with the settled law established by this Court that in applying our tax laws the courts will not exalt form over substance.

FOURTH. The decision of the court below is also believed to be in conflict in principle with the decision of this Court in THOMAS v. PERKINS, 301 U.S. 655. In such case, an oil and gas lease was conveyed to the taxpayer for a cash consideration plus a sum to be paid out of the oil produced and saved from the lands. The Collector sought to tax the assignee with the amounts paid by him over to the assignor on the oil payment. This Court held that the fraction of the oil required to liquidate the oil payment did not pass to the assignee by virtue of the terms of the assignment and that such fraction of the oil reserves had been retained by and belonged to the assignor, and that the assignee was not taxable on the proceeds therefrom. Although this Court did not pass directly on the question of whether the assignor had made a sale of the fraction of the oil that passed to the assignee, it did recognize that a taxpayer owning an oil and gas lease can make a sale of a fractional interest therein and retain a fractional interest. The court below has refused to treat and recognize as a sale a transfer of a lease if an overriding royalty is retained by the transferor and its decision is probably in conflict with the decision of this Court in THOMAS v. PERKINS, supra.

FIFTH. Before the Revenue Act of 1921 gains realized from the sale of property were taxed at the same rates as other income with the result that capital gains often accruing over a long period of time were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provision of the 1921 Revenue Act for taxing capital gains at a lower rate, reënacted in one form or another in all subsequent Revenue Acts, were "*adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments and to remove the deterrent effect of those burdens on such conversions.*" BURNETT v. HARMEL, 287 U.S.

103, and HOUSE REPORT NO. 350, WAYS AND MEANS COMMITTEE, 67th Congress, First Session, on the Revenue Bill of 1921 (App. p. 14).

It is clear from this Court's decision in the HARMEL case and the Report of the Committee on Ways and Means that the new provision of the Revenue Act of 1921 taxing capital gains at a lower rate than ordinary income was taxed was intended as a relief measure. This Court has repeatedly held that relief statutes are to be construed liberally in favor of taxpayers in order that they will receive the benefit of the relief the statutes were intended to provide. BONWIT TELLER & Co. v. U. S., 283 U.S. 258; U. S. v. MERRIAM, 263 U.S. 179; BOWERS v. NEW YORK & ALBANY LIGHTERAGE CO., 213 U.S. 346; U. S. v. UPDYKE, 281 U.S. 489; and BURNETT v. NIAGARA FALLS BREWING CO., 282 U.S. 648.

The gain involved in this proceeding resulted from the conversion of a capital asset, namely: an interest in an oil and gas lease on which there were six producing oil wells at the time of the transfer. The lease had been held by the partnership for the requisite length of time for the gain on the transfer to be taxed as long-term capital gain. All of the gain did not accumulate in the year of realization. It accrued over the period of time the lease was held and owned by the partnership. If the gain is treated as ordinary income, 100% of it will be taxable; whereas, if it is treated as long-term capital gain, only 60% will be includible in income. If the gain is treated as ordinary income, it will fall in a higher surtax bracket than it would if treated as long-term capital gain; consequently, petitioner is within that class of taxpayers which the capital gain provisions were intended to reach and benefit by relieving them from excessive surtax burdens when a capital asset is converted at a profit.

Notwithstanding the above situation, the court below held that the petitioner was not entitled to *treat* the transaction as

a sale. In doing so, the court has not construed the statutes liberally in petitioner's favor. On the contrary, the statute has been construed most liberally in favor of the Government. Thus it appears that the court below has violated the principle long since settled by the decisions of this Court that relief statutes are to be given a liberal construction in favor of taxpayers in order to give them the relief the statutes were intended to provide.

It is respectfully submitted that this petition should be granted.

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